IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner.

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR THE PETITIONER

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Cases Cited.

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The petitioner's brief fully expresses its approval and reliance upon:

1. *United States v. Munsey Trust Co.*, (1947), 332 U. S. 234, 91 L. Ed. 2022.
2. *American Surety Co. v. Oscar Hinds, Trustee* (C. A. 10), 1958, 260 Fed. 2d 366.
3. *Phoenix Indemnity Co. v. Hugh A. Earle* (C. A. 9), 1955, 218 Fed. 2d 645.

However in view of the arguments made by the respondent in its brief, the petitioner takes this opportunity to re-

fer to those arguments and show how they are inapplicable to this lawsuit. It is our purpose in this brief to affirmatively expose to this Court the legal justification of the results in the case of *Henningson v. United States Fidelity & Guaranty Company*, 208 U. S. 404 (1908) and those cases which have followed it by a candid discussion of the cases which respondent, the Circuit Court of Appeals for the Second Circuit, and the District Court wholly depend upon.

In the public contract field the Government merely exacts from the contractor the requirement that the job be timely and satisfactorily performed, without consideration of laborer's and materialmen's payment as an element thereof. It need not be concerned with the possibility of mechanics liens for it is immune from such. In fact, the Government divests itself of all concern in this regard in two ways: Primarily, it does not contract to pay out of pocket the expenses of providing labor and material if the contractor should not. Indeed, the contract, both old and new, is quite clear in this regard. Second, whatever considerations of fairness and equity the Government might have felt toward such claimants were reflected and satisfied in the passage of the Heard and now Miller Acts.

However, in 1908 this Court rendered its opinion in *Henningson v. United States Fidelity & Guaranty Company*, 208 U. S. 404, and thereby created confusion and misunderstanding which multiplied with the cases which followed it. Though the surety's adversary therein was a bank which had lent funds to a contractor, the principles of subrogation set forth would seem analogous to the situation presently before this Court. In that opinion, Mr. Justice Brewer, speaking for the Court, at page 410 said:

> Is its (the surety's) equity superior to that of one who simply loaned money to the contractor, to be used as he saw fit, either in the performance of his building con-

> tract or in any other way? We think it is, it paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supplymen were paid.

The Court found for the surety, apparently asserting it was subrogated to the position of the Government. The only authority textually relied upon by the Court was *Prairie State National Bank v. United States* (164 U. S. 227).

We contend that *Henningson*, though handed down over forty years ago and followed without discussion or rational analysis since then, is unfounded, both as a matter of logic and precedent.

The *Prairie* case was a performance bond case. We do not dispute that a surety is properly subrogated to the legal rights of the Government in such a case, for it is clear that the surety does satisfy a debt which is owed the Government by the contractor, and, thus, may step into the shoes of the Government, the one who it has benefited, asserting whatever rights the Government could assert. It is clear that the Government may use the retainages to complete performance. The contract so provides. Indeed, as this Court in *Munsey* pointed out, this is the only motive the Government has in retaining the percentages. Thus, a perfect example of the proper application of the subrogation doctrine is made out.

But, the conceptual difference between the respective rights of the parties in a performance bond case and a payment bond case indicates most strongly that the two are not similar; in fact, they are not even analogous. Restating our earlier discussion, the Government does not

contractually owe the laborers and materialmen anything; the Government does not by operation of law owe the laborers and materialmen anything. It, as an entity with a conscience, merely must observe its wish for fairness and equity. But, this is not a legal obligation in any sense of the word; notwithstanding, the Government, in pursuit of its sense of equity, provided for the protection of laborers and materialmen—made it necessary that a surety company exercising its commercial judgment under the experienced hand of actuaries, provide a bond for their protection. If any equity was present, the Government has discharged it.

Henningson is unsatisfactory in another, most basic respect. Equity has provided two vehicles—subrogation and reimbursement—to the end of having he, who in good conscience should pay another, make such payment. The Court in *Henningson* seems to have confused these doctrines and, in its confusion, misinterpreted their intended application. These vehicles were intended to protect a surety, whether commercial or private, where it pays a debt for which another is *PRIMARILY* liable. If the Government is an obligor, as *Henningson* seems to say, it is only an equitable obligor; that is, one who may have a moral duty to satisfy an obligation which it may discretionarily observe; but it is not an obligation which the Government must, under the compulsion of the law, satisfy. Certainly, the Government is in no way a PRIMARY OBLIGOR. Thus, whether the Court meant to say that the surety had a direct right against the Government for reimbursement to the extent of the funds in its possession, or indicated that the surety had a right to such funds by way of subrogation to the discretionary right of the Government to observe its moral obligation, it should not have stated it in terms of the equitable devices of subrogation

or reimbursement. The concept simply does not fit the situation present.

Nowhere in *Henningson* does the Court mention subrogation to the rights of laborers and materialmen by the surety. In fact, after quickly noting that the bank has no such right, it passed the subject completely and dwelt on *Prairie* as its sole ground of decision.

Yet, another case, *Belknap Hardware & Manufacturing Company v. Ohio River Contract Company,* (1921) 271 Fed. 144, gratuitously provided such an interpretation of *Henningson.* The Circuit Court of Appeals for the Sixth Circuit, speaking in 1921, commented on *Henningson,* at page 148:

> In that case, the surety upon a bond of this kind * * * and who had been compelled to pay its surety obligation, was held entitled to priority in the fund as against a general creditor of the contractor. The case was *essentially different* from the Prairie State Bank Case, because there the surety had taken over and completed the contract and the performance of the contractor's obligation to the United States as the other party to the contract, and so had become entitled to the security which the United States held against the contractor; in the Henningson Case, the contractor had completely performed the contract and had finished the work. It would seem, therefore, that subrogation in the Henningson Case could not be to any security which the United States held against the contractor; there was no such element in the case.

Such statement if left to stand alone, would be in full agreement with our formerly stated contention; that is *Henningson* did say that, *Henningson* did depend in its entirety upon *Prairie State Bank,* and therefore, Henningson, both as a matter of precedent and logic, must be overruled.

However, as many courts are wont to do in order to save the surety, *Belknap* went on, at page 148, saying,

> (In Henningson) The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated. This is not stated in the opinion in very express terms, but it had been pressed upon the court (cites omitted) that there could be no subrogation without such a right, and that there was no such right.

The inferences build upon each other, and the opinion totters, for the necessary corollary of an equitable obligation is not a legally enforceable right. Certainly, if one morally owes to another something, the other can assert that it should or ought to be paid. But, it is quite another thing to equate "oughtness" with "absolute obligation." Though the *Belknap* Court said that the laborers and materialmen have a "continuing equitable priority" in the fund—symbolically synonomous with "oughtness"—it held that such equitable priority is an absolute legal right.

This very Court, earlier in its opinion, recognized the weakness of its own position, by saying, at page 147:

> It is commonly held that this lien or priority (Mechanics Lien) is wholly statutory, and we are not aware of any case * * * where, without the aid of any contract or statute, this vague equity of materialmen and laborers has been thought sufficient to put the owner of the property under obligation to see that they were paid before he settled with the contractor.

Moreover, the Court in the Belknap case evidenced its own misgivings when it said at page 149 of its opinion:

"Obviously, the retained fund is devoted to the payment for such labor and material as may be necessary to finish the work after the contractor defaults. Whether it is devoted to pay the contractor's debts of this class is a distinct question and the cited cases suggest to us some confusion of thought on the subject."

Again, nothing is clearer than the total absence of any contractual or statutory relationship between the owner—the Government—and the laborers and materialmen. The contract allows payment of all retainages upon timely and satisfactory performance by the contractor; indeed, it provides that after fifty per cent of the job is completed, no further retainages need be withheld. There is no federal statute permitting mechanics liens on federal structures; indeed, case law prohibits the imposition of such.

We contend that *Belknap*, as the birthplace of cases which extend *Henningson's* statement of "subrogation" or "reimbursement" to an "Equitable priority" or "equitable lien" on the fund, is in error, is internally inconsistent, and states an unfounded conclusion that a Governmental "equitable obligation" necessarily means laborers and materialmen have a legally enforceable "equitable priority" which is superior to the right of other claimants.

Other courts have sought to justify their position by stating that the enactment of the Heard Act, the predecessor of the Miller Act, was a "precursor of judicial recognition of an enforceable equitable right of unpaid furnishers of labor and materials" to funds held by the Government subsequent to completion of construction. But does a common law right, which under our system of jurisprudence is founded upon reason and precedent, spring from a legislative enactment where such enactment was prompted by the absence of any legal or equitable recourse. It would seem not.

The statutory bond was provided so that laborers and materialmen might share a similar degree of protection afforded those in the private field, but absent in the public field. The enactment recognized that the law did not and could not provide such protection. Congress could easily have amended the standard form of the Government contract by making the Government a guarantor of payment of laborers and materialmen by the contractor. This it did not do. Instead, it required a commercial surety to so guarantee the payment. In this context, how may a surety claim that, because the Government has required a surety to pay if the primary obligor does not pay, the Government is under any obligation. Again, the inferences build upon each other and the reasoning totters.

It is our contention that, whatever the bulk of case law, whatever the period of its existence, whatever the sophistication of the courts which have followed it, the line of authority which rests on *Henningson*, and ultimately, *Belknap* is in error and must be overruled.

The Court of Appeals for the Second Circuit rests squarely on the Henningson case and therefore its order and judgment must be reversed and the order of the Referee in Bankruptcy of June 9, 1961, be reinstated.

RAYMOND T. MILES,
Counsel for Petitioner.

September 26, 1962.